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Impairing Globalization: The Russo-Ukrainian War, Western Economic Sanctions and Asset Seizures

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Abstract: The potency of economic sanctions imposed on nations depends on demand and supply adjustment possibilities. Adverse GDP impacts will be maximal when import, export, production, distribution and finance are inflexible (universal non-substitution). This paper elaborates on these conditions and quantifies the maximum GDP loss that Western sanctions could have inflicted on Russia in 2022–2023. It reports the World Bank's predictions, contrasts them with the results and draws inferences about the efficiency of Russia's workably competitive markets. This paper shows that Russia's economic system exhibits moderate universal substitutability and is less vulnerable to punitive discipline than Western policymakers suppose. The likelihood that economic sanctions will compel the Kremlin to restore Ukraine's territorial integrity ceteris paribus is correspondingly low, even though war reduces Russia's quality of existence. Western economic sanctions serve narrow geostrategic ends that are reconcilable with Pareto-efficient free trade and globalization, if precision-targeted, but as the Russo-Ukrainian war intensifies, an expanded array of novel and dubiously legal sanctions is degrading free trade, and spurring de-globalization and anti-Western coalitions. If this armed combat is prolonged, the goals of free trade and globalization could be set back for decades.

Keywords: Russo-Ukrainian War; economic sanctions; western security; trade diversion; de-globalization; frozen assets; Russian economic performance; Russian economic prospects; rational choice; quality of existence

JEL Classification: F51; F52; P51; P52

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1. Introduction

Globalization as conceived in the West is a process of transforming non-Western societies into progressive, democratic free enterprise systems founded on Pareto-efficient free trade and international labour mobility.[1] The terms of trade in a harmonious global community are determined competitively, and there are no politically motivated barriers to entry. All members of the community maximize their utility. Within this limit, free trade is Pareto-ideal, assuming political tolerance (Popper 1945). If this condition is violated, globalization is necessarily Pareto-inferior with illiberal consequences. Geopolitically imposed barriers to trade will reduce living standards, and intolerance will impair the quality of existence.

The West's globalization agenda has been set back by rivalries within the West, between NATO and Russia and among the West, China and the Global South, compounded by stern economic sanctions, secondary sanctions on third parties, oil price caps, asset freezing, frozen asset collateralization, impoundment, the Russo-Ukrainian War and related armed conflicts.

This essay investigates the main aspects of sanction-driven de-globalization, identifying the purposes, promises, outcomes and alternatives without taking sides. It finds that Western leaders persistently overestimate sanction benefits and underestimate direct and indirect material costs as well as losses in the quality of living and de-globalization.

This study recommends that politicians everywhere rediscover the virtue of Pareto rational choice calculus and discard winning-at-all-cost thinking.

2. Economic Sanctions

Economic sanctions including trade embargoes and bans on SWIFT bank-clearing transactions are punitive geopolitical measures employed by governments against states, businesses and individuals to chasten misbehavior (Morgan et al. 2023; Cipriani et al. 2023; Jentleson 2022; Rosefielde and Bernstam 2024).[2]

They are geopolitical instruments that signal disapproval and are useful in this sense even if they fail to chasten offenders. Economic sanctions are not protectionist tools like tariffs and quotas or tax-generating devices. They are a form of interstate bargaining fostering political ends.

Economic sanctions may have unintended adverse effects on the West and non-aligned parties, but politicians seldom attempt to minimize them. Symbolism and geopolitical impact are more important than efficiency.

Powerful economic sanctions sometimes may deter aggression and escalation, compel de-annexation and defeat adversaries.

The potency of sanctions partly depends on transgressors' attitudes. Foes may be blasé, conciliatory or intransigent.

The Kremlin is sometimes accommodative. The Soviet Union under pressure from the Jackson–Vanik amendment to the Trade Act of 1974 lightened restrictions on Jewish emigration to improve East–West relations.

Economic sanctions also may serve as a device for funding proxy wars and compelling adversaries to pay reparations for damages caused by their aggression.

They can be used to establish and preserve hegemony and slow the pace of waning geopolitical power.

Policymakers recognize that economic sanctions are likely to be political face-saving devices (Jentleson 2022), unless paired with military coercion.

3. Russo-Ukrainian War

Once the Biden administration committed itself to arming Ukraine on 10 November 2021 (U.S. Department of State 2021; Rosefielde 2023; Slawter 2024), it began fashioning stern sanctions to support NATO's mission (RFE 2019; Mulder 2022, 2023, 2024; Johnson 2024).

NATO did not declare war on Russia or openly engage in an armed struggle to expel Kremlin forces from Ukraine. It chose instead to wage a proxy war against Moscow, providing Kyiv with weapons and punishing the Kremlin with stern economic sanctions. This decision precluded a naval blockade and the seizure of Russian assets because the West was not a principal in the armed conflict.

The Russo-Ukrainian war tests the proposition that stern economic sanctions (European Council 2023a), including asset destruction (Entous et al. 2023; Hersh 2023; Rosefielde and Mills 2022; Sherr 2023), significantly and efficiently enhance prospects for restoring Ukraine's 1991 borders, given existing levels of Western military assistance and moral suasion. The experiment shows that stern sanctions failed to pulverize Russia's economy but did reduce worldwide welfare, cause immense collateral damage to some Western nations and innocent bystanders, and accelerate de-globalization (politically motivated diminishment of worldwide free trade and finance).

4. Universal Substitution and Non-Substitution

The impact of Western economic sanctions depends on consumer preferences, input substitution possibilities and factor mobility (Dorfman et al. 1958; Rosefielde 1973, 1998), and absent monetary and "black swan" macroeconomic effects (Taleb 2007). If domestic goods and services including technology and finance are strong substitutes for embargoed imports and exports, variable factors of production are mobile and strong substitutes, and monetary effects are negligible, then sanctions against competitive economies cannot greatly reduce GDP (Stolper and Samuelson 1941; Keynes 1936). Domestic substitutes will swiftly replace embargoed imports, and other types of domestic production will expand to replace lost foreign sales with modest utilitarian sacrifice. Trade diversion may further lessen the bite of Western economic sanctions.

Embargoes must cause some utilitarian loss. If they do not, then there could not have been a competitive basis for trade.

Russia's economy is imperfectly competitive and, therefore, vulnerable to stern economic sanctions. Anti-competitiveness impairs input substitution, factor mobility, product distribution, financial efficiency and trade diversion possibilities. Maximum damage will occur when anti-competitiveness and various other demand and supply-side constraints rigidly fix input use, output, assortment and distribution. If "universal non-substitution" prevails, buyers will refuse to substitute domestic manufactures and non-Western imports for embargoed goods and services (strong non-substitution) and businesses will be hindered from expanding domestic production to replace lost foreign export sales because the variable factors of production are immobile, non-substitutable (marginal rates of factor substitution are zero) and financially constrained.[3] Under these worst-case conditions, workers in embargoed export activities will be permanently unemployed and gross domestic product will be correspondingly diminished. Stern economic sanctions will plunge Russia into deep depression, pressuring Putin to restore the Ukrainian status quo ante.

The impact of stern Western economic sanctions has been mild because Russians satisficed by buying dis-preferred goods and services (forced substitution) when embargoes constrained import choice,[4] and producers, factors, and distributors efficiently responded to embargo-altered demand. Moderate universal substitutability implies that demand for domestic import replacements and domestic products including intermediate inputs will quickly increase after sanctions are imposed, facilitated gradually at first and then more briskly later by improving factor mobility across activities, intra-multiproduct firm factor substitution (Rosefielde and Pfouts 1988) and financial adaptation.[5] Russia preserved high employment because the variable factors of production were moderately mobile and substitutable, and finance was flexible.

Imperfect competitiveness assures that stern embargoes imposed against Russia will significantly reduce consumer utility and living standards (per capita GDP) in the short run.[6] However, their cumulative impact is apt to be bearable because Russian markets are sufficiently flexible; the West's embargo is porous (European Council 2023a); and the Kremlin has cultivated alternative non-Western trade partners like China, India, Turkey, and Iran. Poorer results from the Kremlin's point of view are possible, but only if the Russian economy is straitjacketed by stronger universal non-substitution or destabilized by monetary shocks.

5. Russian Trade Dependency

Exports comprised 25.2 percent of Russian GDP in 2020, and imports 20.6 percent, computed at dollar purchasing power parity prices (WITS 2023). The Kremlin's top export products were natural resources and agricultural products. Rouble shares were similar.

Ceteris paribus, if Russia's economy exhibited strong universal non-substitution, a complete international embargo would have triggered a 25.2 percent contraction in Russian GDP from 24 February to 31 December 2022. This is the maximum instantaneous impact assuming the total cessation of Kremlin exports and strong universal non-substitution.

This figure overstates the maximum contraction because many of Russia's important trade partners like China and India are not participating in the embargo, and Western sanctions are not comprehensive. A rough adjustment for the porousness of sanctions and trade diversion possibilities suggests a maximum GDP loss of 10 percent, a figure in line with the initial estimates of the World Bank (World Bank 2022) and World Forum (World Forum 2022).

Better results from Putin's perspective, meaning smaller contractions in Russian GDP, occurred because universal substitution proved to be moderate. Rosstat (Federal State Statistics Service) and the European Council expected Russia's 2022 GDP to decline by 3–4.5 percent before revising the forecast to 2.1 percent, revealing that the Russian market system is adequately competitive. Russia's economy displayed good import substitution, labour mobility, factor substitution and financial adaptation (European Council 2023b; Kumar 2023).

Although many Western observers contended that G-7 and EU trade embargoes including SWIFT transfers would devastate Russian GDP and guarantee Ukrainian victory (Thompson 2022), they were confounded when Russian consumers sub-optimized, and variable factors of production and finance proved moderately substitutable and mobile. The Russian GDP in 1989–1998 fell more than 44 percent during the early post-communist transition due to Gorbachev's and Yeltsin's dysfunctional markets (Bush 1999), but Western trade embargoes in Putin's workably competitive market have not sharply diminished Russian GDP, critically constrained war funding or even significantly curbed imports. The likelihood that Western sanctions will force Putin to withdraw from Ukraine is correspondingly low because Russia's workably competitive market institutions are responding constructively to internal and external shocks. Future gains in technological progress should mitigate the deadweight loss further, even if stern sanctions never expire.

6. Technological Progress

Western leaders contend that they will intensify and tighten sanctions until Kyiv with NATO assistance wins the Russo-Ukrainian war but face the prospect of diminishing returns (European Commission 2023). The World Bank believed in late 2022 that sanctions might reduce Russia's GDP a few additional percent in 2023 (Congressional Research Service 2022) but recently reversed itself, forecasting a 2.5 percent gain (Kumar 2023). The full 2022 lower bound GDP deadweight loss from sanctions now is 2.1 percent below the 2021 benchmark. It will persist until the West rescinds its sanctions, even though future productivity growth may conceal the deadweight burden.

The deadweight loss cannot be entirely undone so long as stern Western sanctions persist. If the Russo-Ukrainian war is settled and sanctions annulled, the gain in trade efficiency should significantly increase GDP, providing Putin with a peace dividend for restoring the status quo ante.

Many analysts, assuming moderate non-technology substitution, contend that the static deadweight loss is the tip of the iceberg, that the value of foregone GDP growth exceeds the static sacrifice. Anders Aslund and Maria Snegovaya believe revoking Western sanctions on direct foreign investment and technology transfer would increase Russia's sustainable GDP growth rate by 3 percent per annum (Åslund and Snegovaya 2021). If Russia's natural annual rate of GDP growth (Solow 1956), driven by technology diffusion, capital deepening and catchup effects, were 3 percent without technology transfer, as the World Bank predicted after the 2008 global financial crisis, then in accordance with Aslund and Snegovaya's hypothesis, normalization will increase the Russian GDP growth rate to 6 percent per annum. If Moscow relies solely on non-Western technology transfer, this figure falls to 4.5 percent.[7] The deadweight dynamic loss under this assumption for 2022 was 1.5 percent per annum.

The power of compounding should swiftly make the dynamic deadweight loss from stern sanctions greater than the static sacrifice, but rapid catchup is possible soon after the latest generation technology transfer is resumed, reflecting cumulative improvement after 2022.

Russian policymakers may grasp the expected static and dynamic costs of Western economic sanctions. Estimates of the impact of the Western sanctions in 2014–2021 like Aslund and Snegovaya's were published before the Russo-Ukrainian war (Gurvich and Prilepskiy 2016, 2019). If the Kremlin is conversant with them, the principle of revealed preference indicates that the sacrifice is not great enough to induce Putin to restore Ukraine's territorial integrity.

Washington and Brussels acknowledge that the impact of stern economic sanctions has been less than they predicted. Policymakers are chagrined (Tan 2023) but remain optimistic and are inclined to continue treating sanctions as potent geopolitical gestures, even if Putin never relents (U.S. Department of State 2023a, 2023b).

7. Russian Adjustment

Stern sanctions, including the SWIFT ban (Johnson 2024), failed to crush Russia's economy because factors, product assortments, consumer demand and domestic financing proved to be moderate substitutes; businesses evaded the West's embargo; and the Russian Central Bank still holds large foreign reserves (bne IntelliNews 2023; Shaw et al. 2023). The Kremlin lubricated these adjustments by increasing military spending in 2022. It plans to boost defense expenditures to USD 71 billion in 2023 (Rácz et al. 2023; Luzhin 2022; SIPRI 2023; Freedman 2023). Domestic security and law enforcement spending will rise by nearly the same amount, offsetting diminished demand from foregone industrial exports. Industrial production fell a mere 0.6 percent in 2022. Strong global demand for Russian oil, gas and fertilizer is also a plus.

India sharply increased its consumption of Russian oil, importing 1.2 million barrels each month—33 times the levels seen a year earlier. Turkey imported 213,000 barrels of Russian diesel each day, the most since 2016. Exports to Russia have also proved more resilient than sanction headlines suggest. Russian imports from Turkey in December stood north of USD 1.3 billion, more than double the levels a year earlier. European Union countries spent more than USD 150 billion on Russian fossil fuels from 24 February to 31 December 2022 (Kumar 2023; Simes 2023). Russia even managed to preserve a steady import flow of Western consumer goods.

Western price caps imposed on Russian oil similarly have been ineffective (Economist 2023; Aris 2023d; International Working Group on Russian Sanctions 2022). They neither reduced Russian GDP nor significantly hampered Kremlin war funding (Lawford 2023). Allied sanctions more broadly have not triggered regime change. The West rhetorically remains resolute (Johnson and Wolfram 2023), despite growing unofficial pessimism (Graham 2024), but its punitive strategies do not seem regime-threatening (Aris 2023a, 2023b).

8. Global Adjustment

Western economic sanctions constrained workably competitive utility seeking and reduced Russian gains from global commerce. Diminished trade efficiency harmed most of the Kremlin's commercial partners, but trade diversion benefited some non-Western states by reducing import costs and increasing export demand. Rising energy costs caused by sea-borne petroleum import restrictions and the destruction of the Nord Stream gas pipeline roiled the West. Food price inflation sparked by Russian countersanctions harmed consumers across the globe. Expanded coal usage damaged the environment. Elevated energy prices are hollowing out the German industry (Aris 2023c). Although American and EU GDP growth was strong in 2022, the West underperformed Russia in 2023, while China and India continued benefitting from Russian trade diversion. China has acquired most of Russia's auto production facilities abandoned by Western corporations (Stolyarov and Marrow 2023).

9. Third Party Asset Collateralization and Impoundment

The mounting costs of the Russo-Ukrainian proxy war led Western politicians to consider using Russian financial assets frozen by stern economic sanctions to defray war costs (Boocker et al. 2024) in violation of the property rights protections undergirding free trade for non-belligerents. The West disregarded the possibility at first because it was not a combatant and third-party asset seizures undermine the integrity of global financial systems with potentially catastrophic consequences. Western politicians however were undaunted, devising numerous schemes to impound interest accruing in Euroclear and, then, later collateralizing accrued interest and principal to issue loans of sundry sorts, supporting Ukraine's war effort.

They sought triple political credit for assailing the Kremlin with economic sanctions, providing supplementary financial assistance to Ukraine, and making Russia foot the bill (Becker and Gorodnichenko 2024; Rosefielde and Bernstam 2024; Hill 2024; Tribe and Zoellick 2024; Sonnenfeld et al. 2024; European Commission 2024).

The primary goal was to aid Ukraine with frozen Russian funds derived from Western economic sanctions on private Russian citizens, financial institutions and the Central Bank of the Russian Federation (sovereign debt), held on a custodial basis in Western financial institutions like Euroclear to Ukraine.

The basis for freezing and expropriating some or all custodial holdings and transferring them to third parties is problematic (Subacchi and Lastra 2024), both in multi-national statute and established global legal practice. Freezing Kremlin financial securities and impounding accrued interest because the West sympathizes with the Ukrainian cause is not a universally recognized justification for defaulting on Western financial obligations,[8] but this did not deter the West from insisting that its construction of the law "is" international law. Russia, China and most of the Global South reject the West's right to speak for the rest, but Washington and Brussels ignore their objections.

The West's assertion of its third party right to impound Russia's assets is a large step toward punishing Russia by making the Kremlin pay part of Ukraine's war costs, but it undermines the contractual foundation of the global financial system supporting globalization.

The misappropriation of accrued interest on financial assets sold by America and Europe to Russia constitutes a default on the West's obligation to fully repay its debts. When Washington impounds accrued interest due to Russia by the US Treasury Department, it puts China and others on notice that the West may do the same to them. The prospect of capricious default, regardless of Washington and Brussels' rationalizations, could prompt China and others to cut their lending to Western governments by trillions of dollars, triggering a global spike in interest rates.

10. Reparations

The European Union's evasive statement that it will employ multiple devices to fund Ukraine's war effort and reconstruction (Apulia G7 Leaders' Communiqué 2024; European Union 2024; Wintour 2024; Foy and Politi 2024; Sorgi and Hanke Vela 2024) was quickly condemned by those who construe economic sanctions to require Russia to fully compensate Ukraine and the West for the costs of the Russo-Ukrainian proxy war (Wall Street Journal 2024). This places a new twist on the concept of economic sanctions, interpreting them to require prepayment of war reparations to proxy warriors.

11. Secondary Sanctions

The West, frustrated by Russia diverting trade from the West to other sources, is aggressively denying circumventors access to SWIFT, effectively substituting Western geopolitical dictate for free trade and making a mockery of globalization. Individuals and businesses under NATO's proxy war rules are only permitted to utility seek when Western politicians permit them to do so, spurring de-globalization (politically motivated diminishment of worldwide free trade and finance) by pitting the West against the rest. If the West loses the Russo-Ukrainian War, it still might continue using secondary sanctions with innovative justifications pressuring primary and secondary parties to acquiesce to Washington's political dictate (Miller and Nowak 2024; Lewis and Lawder 2024).[9]

12. Escalation

Increasing Western military support for Kyiv in tandem with expanding secondary economic sanctions against nations assisting Russia in circumventing primary sanctions is impairing globalization by creating ever greater barriers to free commerce among the West, East and Global South, including de-dollarization.

China, Russia and India, fearing Western economic sanctions, have developed substitutes. China's surrogate is The Cross-border Interbank Payment System (CIPS). It offers clearing and settlement services for its participants in cross-border renminbi (RMB) payments and trade. In 2022, CIPS processed around CNY 96.7 trillion (USD 14.03 trillion), with about 1427 financial institutions in 109 countries and regions connected to the system. Russia's substitute clearing system is called The System for Transfer of Financial Messages (Russian: Система передачи финансовых сообщений). It serves 20 states and 550 organizations.

The rapid development of CIPS and SPFS is not only contributing to the partial de-dollarization of the global financial system but also strengthening the Sino-Russian coalition, separating the East from the West, enhancing Russia's ability to prolong the Russo-Ukrainian war and fostering de-globalization.

The short-term antidote for the damage done to globalization by primary and secondary Western economic sanctions is the negotiated de-escalation of the Russo-Ukrainian War and improved rules of proxy war economic sanctions that optimize NATO's utilitarian net benefit (minimizing unintended collateral damage) instead of crushing Russia's economy.

13. Conclusions

Punitive economic sanctions imposed by the West on Russia to restore Ukraine's status quo ante failed because Russia's workably competitive market-driven wage, price, supply, and distribution adjustment mechanisms proved moderately effective. Although sanctions initially reduced Russian GDP at great global economic cost, Russia's economy subsequently rebounded impressively.

Market forces thwarted Western policymakers' intentions. Putin did not capitulate. This was not a fluke. Sterner sanctions given moderate universal substitutability would not have appreciably increased Russia's GDP losses and would have further diminished global welfare.

The revealed preference suggests that the West will continue claiming that economic sanctions will compel Russia to yield until the proxy war is settled. Washington and the EU will not bother devising smarter net benefit optimizing sanctions that preserve embargoes on military exports to Russia while mitigating losses sustained by global producers and consumers. The Biden administration presumably feels that it is wise to keep up appearances and will continue upping the ante by impounding interest on frozen Russian assets, collateralizing these assets and working to impound the principal as partial prepayment of war reparations despite the risk of destabilizing the global financial system. The West likewise will continue pressuring Putin by expanding secondary economic sanctions even though they are strengthening the Sino-Chinese and Russo-North Korean coalitions, antagonizing the Global South, degrading free trade and impairing globalization (politically motivated diminishment of worldwide free trade and finance). It is a big price to pay for the illusion of success.

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Notes

1 If the Pareto efficiency standard is discarded, then any politician can claim that the existing trade regime is best from their geopolitical perspective.

2 Sanctions prohibit adversaries from importing goods and services from the embargoing nations and selling their domestic outputs abroad. For a full assessment of economic sanctions, see (Morgan et al. 2023).
SWIFT is a messaging service that facilitates information exchange between banks and other financial institutions. It connects more than 11,000 entities worldwide.

[3] Zero marginal rates of factor substitution occur when isoquants are rectangular. Leontief input–output tables are constructed with rectangular isoquants. Domestic manufacturers in multiproduct firms producing import substitutes and embargoed export goods can increase output by reallocating variable factors from embargoed exports to import substitutes, despite the strong restriction non-substitution places on single-product firms.The West embargoes Russian imports and exports. The export embargo does not directly affect domestic consumption in the strong non-substitution case. The West's import embargo prevents Russian consumption of foreign goods. This is a deadweight loss, given strong non-substitution because, under strong non-substitution, domestic substitutes cannot replace embargoed imports.

[4] The export embargo affects domestic employment and derivative demand for imports.

[5] Intra-multiproduct firm, inter-enterprise, inter-sectoral and inter-distributional factor mobility and substitution normally will differ across activities. Embargo-imposed forced demand substitution and moderate factor substitution and mobility will shift production downward from the production possibility frontier and alter the product mix. The precise effects of these adjustments are computable in principle, given perfect information. See (Rosefielde et al. 1985).

[6] The effect on consumer or other sovereign utility is assessable with a Bergson social welfare function. See (Bergson 1938, 1954, 1976; Kahneman 2011; Rosefielde 2023). Bergson's social welfare function transforms outputs into consumer utilities, expressed cardinally in national currencies. Exact utilitarian calculation is impossible (Rosefielde and Pfouts 2014). The sovereign decides the appropriate policy action on whatever decision criteria they prefer.

[7] This adjustment assumes that Russia receives technology transfer from non-Western suppliers and leakage from the West. The figure is conjecture.

[8] The West does not acknowledge that failure to pay interest on securities owned by Russia is a "default", claiming Western governments have the right to expropriate interest payments on frozen securities held by custodians like Euroclear. The West, in its view, is not defaulting. It is impounding interest. The US Treasury stills pay interests on Russian-owned debt. It is Congress that confiscates it. https://en.wikipedia.org/wiki/International_sanctions_during_the_Russian_invasion_of_Ukraine (accessed on 31 August 2024)

[9] "Imposing sanctions and trade restrictions on China would be as disruptive as sanctions have been on Russia's auto industry, with dramatic implications for the world economy".

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